ONTARIO ENERGY BOARD

COST ASSESSMENT MODEL

March 14, 2005

(March 16, 2005: last paragraph of S. A2, page 9 revised)

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EXECUTIVE SUMMARY

The purpose of this report is to outline the new Cost Assessment Model for the Ontario Energy Board ("the OEB"). The Introduction provides context related to the development of the new model. Part II outlines the new Cost Assessment Model. Part III discusses some of the key implementation issues for the OEB. The report focuses on the key aspects of the Cost Assessment Model, and does not address related changes in the OEB's administrative processes.

Under the new Cost Assessment Model, the criteria for inclusion of market participants in the general assessment process are: their rates are regulated by the OEB; their key activities are subject to regular and routine supervision by the OEB; and their contribution would not lead to inequitable results for customers.

However, the establishment of the OPA and the recent legislative changes to the roles of the OEB and the IESO will have significant impact on the level and type of activity and interaction among these three entities. Further, the role of electricity generation facilities designated by Regulation is also evolving. The Board will study these impacts, using the experience in the 2005-06 transition year to determine whether to make a recommendation to the Government to include the IESO, the OPA, and the designated facilities designated by Regulation as Classes beginning in 2006-07.

Both direct and indirect costs will be allocated across all assessed "Classes". Indirect costs will be allocated in proportion to the direct costs of the Class.

The total amount assessed to each Class will be apportioned to individual market participants within the Class. For the Gas Distribution Class the basis will be *net revenue*; for the Electricity Distribution Class the basis will be *distribution revenue*; and for the Electricity Transmission Class the basis will be *transmission revenue*.

There will be an annual registration fee of $800 for each license held. The existing license application fee will be increased to $800.

Assessments will be billed quarterly, in advance, based on the approved OEB Budget. An operating reserve will be established in the amount of 15% of the annual funding requirement. It will be charged in 3 equal installments over 3 years, beginning with the 2005-06 fiscal year. Operating surpluses will also contribute to the accumulated reserve.

In future periods, the accumulated operating reserve may be adjusted to equal 15% of the then current annual funding requirement. Should the accumulated reserve exceed the 15% reserve cap, the accumulated surpluses from under spending and the operating reserve assessments will be used to reduce amounts payable under the general assessment.

I - INTRODUCTION

1. General

The energy market and the OEB's mandate have changed. In addition to rate setting, the OEB's role includes rule making, licensing and monitoring compliance of market participants, responding to consumer inquiries and complaints, and providing consumer information and education. It is appropriate for the OEB to re-examine its Cost Assessment Model in the context of the current mix of market participants and with an understanding of how activities associated with each type of participant drive the OEB's costs.

2. Report of Navigant Consulting

Pursuant to a competitive procurement process, the OEB commissioned Navigant Consulting Ltd. ("Navigant") to undertake a study and recommend a cost assessment model.

3. Stakeholder Consultation

On November 1, 2004, all natural gas and electricity market participants were invited to participate in stakeholder consultations related to the recommendations in the Navigant report. In addition to informal feedback, the OEB received sixteen written responses. All stakeholder feedback was carefully considered by the OEB.

4. Guiding Principles

The following guiding principles were set out during the development of the model.

1. Ultimately, customers pay all regulatory costs. The Cost Assessment Model should be: clear and direct, fair, transparent, cost effective and provide incentive to use regulatory services efficiently.
2. The Cost Assessment Model should ensure that ultimately costs incurred in regulating the customer groups are recovered from those customer groups.
3. The Cost Assessment Model should allow the OEB to be financially self-sufficient and avoid the need to borrow funds.
4. All licensed market participants should contribute to the OEB's funding.
5. The Cost Assessment Model should strive for stable and predictable assessments and/or fees for market participants.
6. The OEB should seek to mitigate year-over-year volatility in the apportionment of its funding requirements to each Class of market participant.
7. Allocation within a given Class of market participants should balance fairness, accuracy and predictability where possible.

There were trade-offs in consideration of these principles, which were intended to be guiding principles only to assist in focusing discussion of the issues. The OEB believes, however, that the new Cost Assessment Model reflects an appropriate balance of the guiding principles.

II – THE COST ASSESSMENT MODEL

The OEB recovers its operating and capital costs from the natural gas and electricity market participants that it regulates. This represents the majority of OEB's revenues.

The OEB's revenues arise from the following:

a) Recovery of costs incurred in respect of particular proceedings and other processes under s.30 of the *OEB Act, 1998*;

b) Fees charged under s.12.1 of the *OEB Act, 1998*;

c) Income earned on investments;

d) General cost assessment to recover all remaining costs[1], under s.26 of the *OEB Act, 1998;*

e) Penalties assessed against individual market participants under s.112.5 of the *OEB Act, 1998.*

The Cost Assessment Model is the approach used by the OEB to set fees (b above) and to calculate and apportion the general cost assessment (d above) among the market participants.

General cost assessment is done in three steps.

- The total amount to be recovered by general assessment is determined based on the OEB's overall requirements less other funding sources (as above).
- The total amount is then apportioned among categories of market participants or "Classes".
- The amount apportioned to each Class is then apportioned to the individual market participants within the Class.

The following sections outline the OEB's new Cost Assessment Model.

Section A – What are the Classes of market participants for general cost assessment?

[1] As outlined in Section E3, penalties reduce the general assessment only as it relates to the operating reserve.

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Section B – How is the general cost assessment apportioned across the Classes?

Section C – How are costs apportioned to individuals within each Class?

Section D – The OEB's fee revenues.

Section E – The nature of billings for the general cost assessment, including operating reserve amounts.

A. CLASSES OF MARKET PARTICIPANTS

A1. Criteria for Including Market Participants in General Cost Assessment

The OEB will include market participants in the general assessment process if:

- their rates are regulated by the OEB; and
- their key activities are subject to regular and routine supervision by the OEB; and
- their contribution would not lead to inequitable results for customers.

The following are the Classes of market participants under the OEB's new Cost Assessment Model.

- Gas Utilities
- Electricity Transmission
- Electricity Distribution

A2. Market Participants Not Included

The OEB did not include the Independent Electricity System Operator, the Ontario Power Authority, Gas Marketers, Electricity Retailers, Electricity Generators (including designated facilities), and Electricity Wholesalers categories of market participants as Classes for general cost assessment in the new model. The following explains why.

a) The Independent Electricity System Operator and the Ontario Power Authority

Under the preceding criteria, the Ontario Power Authority (OPA) and the Independent Electricity System Operator (IESO) would be included in the cost assessment.

However, the establishment of the OPA and the recent legislative changes to the roles of the OEB and the IESO will have significant impact on the level and type of activity and interaction among these three entities. The Board will study these impacts, using the 2005-06 experience to revisit whether the OPA and/or the IESO should be included as Classes beginning in 2006-07.

b) Electricity Wholesalers

The OEB does not generally have regular activity related to these entities and the added complexity and administrative cost of introducing a separate Class is not warranted.

c) Electricity Generators

In general, electricity generators have limited activity with the OEB. Certain rate regulated electricity generation facilities are prescribed by regulation pursuant to s.78.1 of the OEB Act, 1998 to be "designated facilities". The Board does not currently regulate the prices of the output of such facilities. However, in anticipation of activity related to the regulation of designated generation, the Board will monitor how the Board's work related to designated facilities evolves and the cost of this activity to determine whether it should recommend that designated facilities be included as a Class beginning in 2006-07.

d) Competitive Suppliers (Gas Marketers and Electricity Retailers)

The rates of competitive market participants are not regulated by the OEB, and their inclusion in the General Assessment would lead to inequitable results for customers.

Much of the OEB's cost that is uniquely associated with retailers/marketers relates to compliance and enforcement. The OEB can and will collect the costs of proceedings (i.e., outside of the general cost assessment process) that directly relate to marketers/retailers.

The OEB model ensures that all market participants share in the OEB's costs. In this regard fees have been expanded to include annual registration fees charged for all licenses, in addition to application fees. (See sections A3 and D.)

A3. Assessment Versus Fees

Some of the market participants are not included in Classes under the general assessment. However, based on the principle that a good Cost Assessment Model provides some incentive for efficient use of the Board's services, the Board believes that all market participants should contribute to the OEB's

funding. The Board also believes that this should take the simplest form possible. Given the limited engagement with the Board of a number of market participants, such as wholesalers and generators, the Board believes the simplest and most appropriate way of achieving this is by setting a license fee for all licenses held by market participants of $800.

B. APPORTIONMENT ACROSS CLASSES

B1. General

The general assessment amount will be based on the approved OEB Budget for the year being assessed. Note that future assessments will not be adjusted directly for differences between the budget and actual costs. These differences will impact the OEB's operating reserve. See further details in Section E.

The total amount of the general assessment is apportioned amongst the Classes of market participants.

With respect to general cost assessment under the OEB Cost Assessment Model, costs are considered to be "direct costs" or "indirect costs".

- Direct costs are costs that can reasonably be attributed to the OEB's activities related to a particular market participant group. These costs are attributed to a Class either specifically or ultimately through senior management's apportionment of cross-Class projects.
- Indirect costs are all remaining costs to be recovered by the general cost assessment.

Both direct and indirect costs will be allocated across all assessed "Classes". Indirect costs will be allocated in proportion to the direct costs of the Class.

To improve accountability and in anticipation of the new Cost Assessment Model, the OEB has recently refined its cost tracking capabilities to better enable costs to be assigned to both Classes and major projects for both planning purposes and to track actual costs as they are incurred.

B2. Direct Costs of a Class

In the OEB Cost Assessment Model, direct costs that can be reasonably attributed to a particular market participant group will be recovered from the associated Class.

Examples of direct costs include:

- staff costs related to market operations, policy development, case administration and legal staff, based on time spent on activities related to a particular Class as recorded in the time tracking system;
- call centre costs, based on the nature of calls received;
- specific project costs such as consultants and stakeholder consultation costs for studies related to a particular Class.

Some costs can be directly attributed to a group of Classes (e.g. all electricity Classes) rather than a particular Class. These costs would ultimately be allocated across the relevant Classes based on senior management's apportionment of cross-Class projects.

In cases where costs can be directly attributed to a market participant group that is not a Class for assessment purposes, those costs will be included as direct costs of the closest Class.

B3. Attributing Indirect Costs to the Classes

As noted above, indirect costs are all costs to be recovered through the general assessment process that cannot be specifically attributed to a particular market participant group.

Examples of indirect costs include:

- staff costs for administrative areas of the OEB;
- lease costs for the OEB's premises; and
- other costs that do not specifically relate to a particular Class.

The OEB will use the following formula to allocate these costs in direct proportion to the Class' share of direct costs:

Class share of indirect costs (%) =

$$\frac{\left(\begin{array}{l}\text{Class share of direct staff costs} \\ \quad \underline{\text{plus}} \quad \text{other direct costs of the Class}\end{array}\right)}{\left(\begin{array}{l}\text{direct staff costs for all Classes} \\ \quad \underline{\text{plus}} \quad \text{other direct costs of all Classes}\end{array}\right)}$$

B4. Use of Historical Data

Staff costs will be based on budgeted salaries and actual time tracking data for the most recent 24 month period, unless an adjustment for a significant distortion resulting from a major change in the OEB business plan and budget is deemed necessary by the Board.

Budgeted direct project costs will be apportioned across Classes based on the relative proportions of actual project costs for the two fiscal years prior to the year being assessed. Again, an adjustment for a significant distortion resulting from a major change in the OEB business plan and budget could be made if deemed necessary by the Board.

C: APPORTIONMENT WITHIN EACH CLASS

The total amount to be recovered from each Class will be apportioned to individual market participants within the Class. The basis of intra-Class apportionment for each Class is outlined in this Section.

C1. Gas Distribution Class

Apportionment within the Gas Utility Class will be based on net revenues. Net revenues include distribution revenue as well as transportation of gas for other customers, storage revenue and other revenue, but exclude commodity revenue.

C2. Electricity Distribution Class

Apportionment within the Electricity Distribution Class will be based on distribution revenue.

C3. Electricity Transmission Class

Apportionment within the Electricity Transmission Class will be based on transmission revenue.

D: FEES

All licensees will pay an annual "registration fee" of $800 per license held. Also, the existing initial application fee will be increased from $500 to $800. See also A3.

With the new annual fee all market participants will contribute to the OEB's funding to some extent.

E: ASSESSMENT BILLINGS

E1. Annual Funding Requirement

The OEB's annual funding requirement is the total of operating expenses (excluding depreciation and any other non-cash expenses that may arise) and capital expenditures for the fiscal year as reflected in the approved OEB Budget.

E2. Billing Frequency

Market participants will be invoiced quarterly in advance based on the OEB's overall funding requirement. Each quarterly invoice will be an equal 25% of the annual assessment amount.

E3. Operating Reserve

An operating reserve will be established for cash flow management and to support working capital requirements, in addition to mitigating the financial impact of unexpected circumstances. The OEB is no longer able to rely on the Province of Ontario for cash management and in-year funding.

The reserve will be funded from:

- surpluses from under spending during the year (i.e., when actual amounts are less than the approved OEB Budget, which was the basis for the annual funding requirement amount used for the general assessment);
- surpluses from penalties, which are not budgeted; and
- a charge for 15% of the annual funding requirement, to be assessed in 3 equal installments, beginning with the 2005-06 fiscal year.

In future periods, the accumulated operating reserve may be adjusted to equal 15% of the then current annual funding requirement.

The accumulated operating reserve will not exceed 15% of the annual funding requirement. If the accumulated operating reserve exceeds the 15% reserve cap, accumulated surpluses from under spending and the operating reserve assessment will be used to reduce payments under future assessments.

On the other hand, surpluses from penalties would not be used to reduce payments under the general assessment.

III - IMPLEMENTATION

1. Regulation

The Government has passed a Regulation under the Ontario Energy Board Act, 1998 that establishes the three classes that the OEB will assess under the new Cost Assessment Model as described in this document, for the 2005-06 year. As the OEB is a regulatory body, a legislative framework for recovering costs provides sound accountability to the industries that are regulated.

The Regulation developed for 2006-07 and future years will reflect the experience and further analysis required to determine whether additional Classes will be established in respect of the Independent Electricity System Operator, the Ontario Power Authority or designated facilities (see A2 – Market Participants Not Included).

2. Changes to the OEB's Internal Processes

The OEB has begun to make improvements to its internal processes to implement the new Cost Assessment Model. These changes are an important element for the success of the new Model.

3. Continuous Improvement and Refinement of the Model

The OEB will continue to review and consult on opportunities to enhance the OEB's accountability and foster further transparency of activities impacting its Cost Assessment Model.

As energy markets evolve and change, so may the OEB's role and circumstances. The OEB is committed to ensuring that the Cost Assessment Model remains appropriate.

The OEB will also take advantage of cost-effective processes and technologies as they emerge.

4. Use of Historical Data

As noted above, the OEB is improving its internal processes and making changes required to support the new Cost Assessment Model. In this context, 12 (rather than 24) months of actual historical data will be used for apportionment purposes for the first two implementation years of the Cost Assessment Model.